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28 APR 1978

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Mr. Mike O'Neil, Chief Counsel
Permanent Select Committee on Intelligence
House of Representatives
Washington, D.C. 20515

Dear Mike:

In follow up to our meeting of 25 April 1978 concerning taxation of overseas allowances, attached is a copy of a statement made by Donald C. Lubick, Department of the Treasury, before the House Ways and Means Committee on 23 February 1978. The statement and four-page proposal that accompanied it reflect the Administration's position on section 911 of the Internal Revenue Code, but concern also section 912 (see especially paragraph B on page 3 of the accompanying proposal).

We will keep you informed of our activity on this important matter.

With best regards,

[redacted]
Assistant Legislative Counsel

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FOR RELEASE UPON DELIVERY
Expected At 9:30 a.m.
February 23, 1978

STATEMENT OF DONALD C. LUBICK
ACTING ASSISTANT SECRETARY FOR TAX POLICY
ON
TAXATION OF AMERICANS WORKING OUTSIDE
THE UNITED STATES
BEFORE THE COMMITTEE ON WAYS AND MEANS
WASHINGTON, D. C.

Mr. Chairman and members of this distinguished Committee:

I am pleased to participate in these hearings on the taxation of Americans working outside the United States. This is an important area of tax policy which has been the subject of intense debate.

Much of that debate centers around section 911 of the Internal Revenue Code, relating to the taxation of Americans working overseas in the private sector. Important changes were made to section 911 by the Tax Reform Act of 1976, but it has become increasingly apparent since 1976 that the new rules are unsatisfactory, and in some cases unfair. We would like to see these rules modified in a way that will be both fair and lasting.

In addition to section 911, there is another aspect of the taxation of Americans overseas that could be made more fair. That aspect concerns certain provisions in our tax law which

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presently do not address the special circumstances of Americans living outside the country. I refer specifically to lodging furnished by an employer in remote camps or similar compounds, the moving expense deduction, and the roll-over of capital gains on the sale of a principal residence.

My testimony will briefly describe these problems encountered under the current method of taxing Americans employed outside the United States. I will also suggest some possible solutions to these problems.

I. SECTION 911

In 1975 this Committee voted to phase out the foreign earned income exclusion of section 911 over a three-year period and to replace it with a special deduction for expenses incurred in providing education for dependents and an exclusion for municipal-type services provided by an employer to United States citizens working abroad. The Senate "restored" the earned income exclusion, but made several computational changes, the consequences of which were widely underestimated at the time. The two most important computational changes were that the foreign tax credit was disallowed for foreign taxes attributable to the excluded income and that the exclusion was made applicable to the lowest bracket income. The Conference Committee pared the exclusion to $15,000, but adopted the Senate's changes in the computation of the exclusion.

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It soon became clear that for most Americans overseas earning more than $15,000, the amendments made by the Tax Reform Act of 1976 resulted in a significant tax increase. Our estimates show that in the aggregate the 1976 Tax Reform Act amendments would have more than doubled the United States tax liability of Americans claiming section 911 in 1977. The increase intensifies as income levels exceed $15,000.

The 1976 changes brought to light a consideration which might justify relief. That consideration relates to the fairness or equity of our tax treatment of Americans working in foreign locations where they must incur unusually high costs to maintain a style of living comparable to that found in the United States.

Incomes of Americans working abroad often appear high because they include compensation for high living costs. In 1975 this Committee agreed that Americans working overseas should be allowed to deduct certain schooling costs. The Task Force on Foreign Income, chaired by Representative Rostenkowski, agreed and recommended such a deduction with a higher limit than that voted by the Committee. The Administration supports a deduction for education expenses.

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The Task Force on Foreign Income also considered a general cost of living adjustment for Americans working overseas, but the concept was rejected because it would be unfair to taxpayers at home who also face wide variations in living costs without tax relief. As I will explain in a minute, the Administration agrees with this conclusion. However, there are other specific costs incurred abroad that are so excessive by United States standards in general that we believe a special deduction could justifiably be allowed in addition to a deduction for education costs.

A now familiar example is the case of the exorbitant housing costs found in parts of the Middle East and North Africa. If the employer furnishes or pays for an employee's housing in these locations, the local fair market value of the housing is treated as income to the employee. As a result, an employee with a base salary of $20,000 living in housing comparable (or inferior) to United States housing may be taxed on an income of $35,000 or more.

Another extraordinary expense Americans incur by reason of foreign employment is the travel cost of returning to the United States to visit family and friends or to attend to personal business.

The Administration believes it is entirely equitable to make special adjustments for education costs, excess housing costs and home-leave travel costs. However, the Administration believes that any such special adjustment must be easily understood by the taxpayer, that the computations must be as simple as possible, and that the paperwork burden on employers and the administrative burden on the Internal Revenue Service must be kept to a minimum. By specifying

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deductions only for those overseas costs that are truly excessive and by using relatively simple standards of measurement, we think a good balance can be attained. Let me explain how this might work. I am attaching for the record a detailed summary of the Administration's proposal.

Excess Housing Cost: Excessive housing costs have been identified as the most burdensome excess cost of living in many foreign countries. We believe that a deduction should be allowed for the amount by which the cost of reasonable housing in a foreign country exceeds the amount that would typically be paid for housing in the United States. We suggest that this amount be cast as a simple percentage of earned income, reflecting average United States housing expenditures. The bill introduced by Senator Ribicoff and approved by the Senate Finance Committee takes this approach, and we think it is a good approach and could be workable.

Since housing costs vary drastically with different locations, it is impractical to set a dollar or percentage ceiling on the housing deduction. In addition, the substantial burdens of employer certification of reasonableness of housing costs, and the preparation of tables or other guidelines for measuring the reasonableness of housing costs suggest that these approaches not be followed. We believe that it will be sufficient merely to state that the housing deductions will be limited to amounts spent for "reasonable housing," leaving the determination of "reasonableness" to the audit process, as in other areas of our tax laws.

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Education Costs: Because free or low cost English language schooling is often not available overseas, Americans employed abroad often incur substantially higher educational expenses than do their counterparts at home. In addition to costs for tuition, books, and fees, Americans working in foreign countries must often send their children to schools outside the country of their employment, thereby incurring additional costs. The Administration recognizes the need for a deduction for education expenses, as does Senator Ribicoff's bill.

Since primary education is usually available free of cost or at a low cost in local public schools in the United States, we do not believe it necessary to place a floor on deductions for education expenses. A ceiling should be placed on the amount of the deduction to prevent abuse. We support the simple and easily administered approach of setting a ceiling of a fixed dollar amount for each child. This approach was taken by this Committee in 1975 and also by the Rostenkowski Task Force. We propose a ceiling of $4,000 per child per year for tuition, books, and fees (and room and board where necessary) through grade 12. In addition, for college students and where boarding schools are necessary at pre-college levels, we propose a deduction for two economy fare round trips per year per student for travel between the school and the place of the taxpayer's overseas employment.

Home-Leave Travel Costs: Americans employed overseas often visit the United States for family reasons, for medical reasons, or for other personal reasons. The cost of transportation from the

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foreign post to the United States for such purposes can be substantial. Because this cost is easily measured and verified, the Administration proposes that a deduction be allowed for amounts paid for one round trip economy fare every other year for each family member between the foreign place of employment and the most recent place of residence in the United States.

Cost of Living: High costs of living in foreign countries are often cited as added expenses incurred by Americans employed overseas, although other costs generally do not add as much to the employee's burden as do the costs of housing, education, and home-leave travel. The Administration does not propose any special deduction for costs of living, for two reasons. First, we believe that the measurement of this deduction, which necessarily involves many questions of taste and judgment, will cause very substantial administrative burdens, will lead to endless demands for more relief, and will add unwarranted complexity to the tax laws. Second, the Administration agrees with the conclusion of the Task Force on Foreign Income that a cost of living adjustment for Americans working overseas would be unfair to taxpayers at home who also face wide variation in costs of living, without tax relief.

II. Sections 119, 217 and 1034

The considerations underlying our proposals for changes to section 911 also suggest that changes be made to three other provisions of our tax laws that presently do not have special features addressed

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to Americans working in foreign countries. Those changes relate to the exclusion for employer furnished meals and housing under section 119, the moving expense deduction under section 217, and the section 1034 roll-over of capital gains on the sale of a principal residence.

In many remote areas, overseas employers must furnish housing and meals to their employees. Usually, the employee is required to live in housing furnished in camps or similar compounds where the living conditions are significantly inferior to those in the United States. Although the housing and meals are furnished for the convenience of the employer, they are not presently excludable because they are not furnished on the business premises of the employer. The Administration proposes to expand section 119 to allow these overseas Americans to exclude from income the value of employer-furnished meals and housing in such camps, barracks or similar compounds.

Americans moving overseas incur substantially higher moving costs and often must live in temporary quarters for longer periods than Americans moving within the United States. We propose to increase the section 217 time limits for a move and associated temporary living costs from 30 to 60 days, and to raise the ceiling on temporary living costs from $1,500 to $5,000.

In addition, Americans who move overseas for employment reasons and who sell their principal residences when they move may be unable to defer the gain from the sale by purchasing or constructing new principal residence within the 18 or 24 month periods allowed by

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section 1034. In the interest of fairness, we also propose that the 18 or 24 month period for reinvestment of the proceeds of the sale of a principal residence be suspended for a maximum of four years for any taxpayer whose residence abroad qualifies him for the deductions of our proposed section 221 or the exclusion of section 912.

CONCLUSION

The Administration recognizes that these issues present complex problems involving Americans in differing circumstances in various parts of the world. We believe that our proposals provide fair and workable rules that take into account these differing circumstances encountered by our citizens and resident aliens working abroad. However, past experience teaches that the effects of proposals in this area sometimes are not immediately apparent. Accordingly, we are suggesting, as part of our proposal, that the Treasury be required to report to the Congress every two years with respect to the provisions of the tax laws relating to Americans working abroad.

We propose that such reports take account not only of Americans abroad in the private sector but of federal employees abroad as well. Accordingly, we propose that affected federal agencies be required to furnish the Treasury with information that will permit the same kind of detailed revenue studies of the tax provisions relating to federal employees that are possible now only with respect to private sector employees.

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ADMINISTRATION'S PROPOSAL FOR SECTION 911

I. PRESENT LAW

United States citizens are generally taxed by the United States on worldwide income and are entitled to a tax credit for foreign taxes paid. However, there are certain exceptions to this general rule for citizens living and working outside the United States.

Under section 911 of the Internal Revenue Code, as amended by the Tax Reform Act of 1976, United States citizens who remain in a foreign country for 17 months in any consecutive 18 month period or who are bona fide residents of a foreign country and have been for at least one full taxable year may exclude up to $15,000 of earned income. The excluded amount is $20,000 for employees of United States organizations that qualify as tax exempt organizations. No deductions or credits chargeable against income excluded under section 911 may be taken against other income. In addition, the exclusion applies to the lowest bracket income; additional income is subject to United States tax at the rates that would apply if there were no section 911 exclusion.

Prior to its amendment by the Tax Reform Act of 1976, section 911 provided that United States citizens working abroad could exclude up to $20,000 of earned income ($25,000 if they were bona fide residents of a foreign country for more than 3 years). The exclusion applied to the highest bracket earnings. Citizens could claim credit for foreign taxes attributable to excluded earnings, but such earnings reduced the foreign tax credit limitation under section 904.

II. EXPLANATION OF PROPOSAL

The Administration's proposal will replace the existing section 911 of the Code with a new section 221 that provides for special deductions for United States citizens and resident aliens working abroad.

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The Administration's proposal will also broaden the conditions under which meals and housing furnished by the employer are excludable from income under section 119. In addition, section 217 will be amended to provide increased time limits and a higher ceiling for deductions for international moves. Section 1034 will also be amended to provide additional time for persons qualifying for sections 911 or 912 to reinvest the proceeds from the sale of a principal residence without having to recognize gain.

A detailed explanation of the major provisions of the Administration's proposals is set forth below.

A. Changes to Section 911

The Administration's proposal will replace section 911 of the Code with a new section 221 that will give United States citizens and resident aliens who are bona fide residents of foreign countries for an entire taxable year or who are physically present in foreign countries for 334 days during the taxable year a deduction for certain expenses incurred for housing, education and home-leave travel. The amount deductible under the new section will, however, be limited to the amount of earned income from foreign sources. Foreign taxes attributable to amounts deducted will not be disallowed, although the deductions will be attributable to foreign source income and thus will reduce the section 904 limitation on the credit.

(1) Housing: A deduction will be allowed for the excess of the actual amount incurred for reasonable housing (rent and utilities) over 20 percent of earned income net of actual housing costs and the allowable deductions for education and home-leave travel. This 20 percent figure is based on the premise that a typical American living overseas would spend approximately 1/6 of his income on housing if he lived in the United States; 20 percent of $20,000 of earned income net of housing and the other special deductions equals $4,000, 1/6 of $24,000. In the case of housing furnished by the employer, the employee will include in income the full fair market value of the housing (including utilities), but will be allowed to deduct the excess of the fair market rental value over 20 percent of earned income net of housing and the allowable deductions for education and home-leave travel. The deduction for housing furnished by the employer will not be available to taxpayers claiming an exclusion for employer-furnished housing under section 119.

(2) Education: A deduction will be allowed for tuition, books and room and board up to $4,000 per year for each dependent child in grades 1 through 12, plus actual economy travel for two round trips per year between the school and the foreign residence. The transportation deduction, but not the deduction for tuition, will also be available for [illegible] college students.

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(3) Home-leave travel: A deduction will be allowed for one economy round trip fare every other year for each member of the taxpayer's family between a foreign post and the taxpayer's residence in the United States. If the taxpayer maintains no residence in the United States, the deduction will be allowed for transportation between the foreign post and the taxpayer's place of residence before he went abroad.

B. Reports to Treasury and Congress

Under the Administration's proposal, government agencies furnishing allowances excludable by their employees under section 912 will be required to submit annual reports to the Treasury Department itemizing those allowances. The Treasury Department will also be required to present to Congress every two years a detailed description of the revenue costs and economic effects of the exclusions under section 912 and the deductions under the new section 221.

C. Changes to Section 119 (Employer-Furnished Meals or Lodging)

The Administration's proposal will broaden the conditions under which housing and meals furnished by the employer overseas can be excluded from income under section 119. Housing and meals which are furnished in a camp or barracks or similar compound will be excludable from income if they are furnished in the general vicinity of the business premises of the employer or the place where the employee's services are rendered and are furnished because adequate alternative meals and lodging in that vicinity are not available.

D. Changes to Section 217 (Moving Expenses)

The Administration's proposal will also amend section 217 of the Code to increase the time limits for a move and associated temporary living arrangements from 30 days to 60 days, and to raise the ceiling on temporary living costs from $1,500 to $5,000. The increased time limits and ceiling on deductions will apply only to moves from the United States to a foreign country, from a foreign country to the United States and from one foreign country to another. Since the Administration's proposal will replace the existing section 911 exemption with the new section 221 deductions, no part of the moving expenses will be disallowed as attributable to exempt income.

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E. Changes to Section 1034 (Sale or Exchange of Residence)

The Administration's proposal will also amend section 1034 of the Code to suspend the running of the 18 or 24 month period for reinvestment of the proceeds realized on the sale of a principal residence. The suspension will be for a maximum period of four years and will apply only to persons working overseas who qualify for the deductions of the new section 221 or the exclusion of section 912.

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